United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

74-2128

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Pages

To be argued by
ABRAHAM KAPLAN

ORIGINAL

In The

United States Court of Appeals

For The Second Circuit

In the Matter of
MADERO SILKS, INC.,

Bankrupt,

PAULINE GREEN,

Claimant-Appellant,

-against-

MARY JOHNSON LOWE,

Trustee-Appellee.

On Appeal from the United States District Court for the Southern District of New York

REPLY BRIEF FOR CLAIMANT-APPELLANT

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REPLY BRIEF

OF APPELLANT

The brief of Appellant requires certain comments. These will be made in the order that the matter discussed appears in Appellee's brief though not necessarily in the order of their importance to the determination.

I

The Appellee has spent much time in her brief discussing the relations between Centrella and Green, the Appellant, and Centrella and his sister. What is determinative of the issue here presented, however, are the relations between Centrella and the Bankrupt. Aside from the determination by the Referee that Centrella controlled the affairs of

the Bankrupt (APP.p 29) what does appear from the stipulation as to the facts (Appellant's brief, Page 3; Appellee's brief, Page 3) and the record is that on July 16, 1968, the Bankrupt received a check in the sum of $17,000.00 from Appellant, which was deposited to the credit of the Bankrupt's bank account and that at the time of the bankruptcy, the books and records of the Bankrupt reflected an indebtedness of $17,000.00 to Pauline Green as a loan payable.

II

As argued in Point IV of Appellant's brief, whether a particular transaction constitutes a loan or a capital contribution, in bankruptcy, turns on different factors than when such determination is to be made under the Internal Revenue Laws. Nevertheless, the Appellee has seen fit to disregard the distinction and to rely exclusively on decisions in tax cases in her Point I at pages 12 to 16. Even here Appellee has gone astray.

Intolerable confusion has arisen from the "Thin Corporation" rule. As a result, the Courts of each circuit have developed different tests for a determination of the issue. (4, Research Institute "Tax Co-ordinator" §K5105, et seq.) With the hope of resolving the conflict, Congress enacted §385 of the Internal Revenue Code as part of the Tax Reform Act of 1969, authorizing the Secretary of the Treasury

or his delegate to "prescribe regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title, as stock of indebtedness." The Secretary of the Treasury has not seen fit to exercise his authority in this regard, and as a result further confusion is being heaped on the issue.

The only decision of this circuit which Appellee has seen fit to cite on this point is Gilbert v. Commissioner of Internal Revenue, 262 F. 2d 512 (2nd Circuit, 1959). The one on which she most relies is Wood Preserving Corporation of Baltimore, Inc. v. U. S. 233 F. Supp. 600 (D.C.Md. 1969).

With respect to that decision, it is interesting to note.

a.) The dots in the middle of the excerpt therefrom on page 12 of Appellee's brief stand for the following language:

> "The intention of the parties to the transaction in question is an important factor, but their intention should not be found from their testimony alone; and the surrounding circumstances must be considered";

b.) The Court also stated

> "Some of the arguments advanced by Wood Preserving are based upon statements in opinions from other Circuits, particularly Rowan v. U.S.,5Cir, 219F 2d 51 (1955) and Nassau Lens v. C.I.R., 2Cir, 308 F 2d 39 (1962); these cases, however, are distinguishable on the facts and do not control this case";

c.) The Court there held that loans made or created by the control persons at the time when the corporation commenced business, constituted contributions to capital, within the "Thin Corporation" rules, but that a claim based on a loan made five years thereafter, supported by book entries, was proper and should be allowed.

Even applying some of the tests for determining whether a particular transaction is a loan or capital contribution under the tax laws, Appellee has gone wrong.

1) A bona fide debtor-creditor relationship may arise without a written instrument. Particularly in a small corporation, it is most unusual for a control person to insist upon some document to evidence his indebtedness. Reliance ordinarily is upon the books of the corporation. If those reflect a loan, that is usually satisfactory. (Wood Preserving Corporation v. U.S., supra)

2) Neither periodic interest payments, nor a provision therefor, are required to establish the existence of a bona fide loan. In corporations such as the bankrupt here, it is usual that the understanding is that the debt, together with interest, if any, is to be repaid out of future earnings without interim payments either on account of interest or principal. (Miller's Estate v. Commissioner. 239 Fed. 2d 729)

3) The bankrupt was being financed by a factor which continued to make advances to it after the loan under review had been made and continuing to the time of the filing of the petition. (Schedule B, Financial Report of Joseph S. Herbert & Co., Certified Public Accountants, made on behalf of the Trustee in Bankruptcy, which reflects that for the period January 1, 1968 to March 28, 1969 the bankrupt was charged by Mill Factors the sum of $15,250; for factoring interest and commissions.) It follows necessarily therefrom that the bankrupt could not have obtained loans from the usual banking institutions (Appellee's brief, page 14), but this is of no significance. It is a matter of general knowledge of which this Court may take judicial notice that a factor, as security for its loans and advances, insists upon a pledge of all the assets of the borrower. The factor takes the place of usual banking facilities, and it is rare indeed when any bank will make a loan to a factored firm.

4) It is true that the creditor made no effort to collect his debt while the corporation was still operating. Any steps which might have been taken by him to enforce payment would have been prejudicial to the other creditors and might have been condemned as a preferential payment. In this instance the creditor was satisfied to do what the law sanctions: to share ratably with the other creditors of the bankrupt.

III

At page 16 of her brief, Appellee concedes that a loan to a corporation made or arranged by a person found to be in control thereof, may be the basis of a valid claim in bankruptcy, on a parity with other creditors. What will preclude such parity, is some inequitable conduct on his part, some abuse of his control, to obtain an advantage to the injury of the corporation and its creditors.

The principal was stated by this Court in Schwartz v. Mills, 192 F 2d 727 (2d Cir. 1951) in the following language:

> "It is of course true that bankruptcy courts can and must pierce the proverbial corporate veil in the interests of substantial justice to subordinate the claims of corporate affiliates or individual insiders who have obtained an unfair advantage from their favored position. But we do not think that the doctrines expressed in such cases cover the situation at bar. For subordination is not mechanically automatic upon a showing of identity between stockholders of the claimant and debtor corporations; we have traditionally stressed the elements of fraud and actual injury to the debtor's interests, ..."

Even prior to Schwartz this Court had held In re Modelaine, Inc., 164 F 2d 419 (2d Cir.1947);

> "There is nothing illegal in an officer or director lending money to his corporation provided he does not use his corporate position to defraud creditors or take advantage of them. Goldstein v. Wolfson, 2d Cir., 132 F (2) 624, 626; Arnold v. Phillips, 5 Cir., 117 F (2d) 497, 503. The case of Pepper v.

Litton, 308 U.S. 295, 60 S. Ct. 238, 248, 84 L. Ed. 281, is not to the contrary, for there the dominant stockholder used his claim for accumulated salary to defraud another creditor pursuant to a "planned and fraudulent scheme."

The examples of "fraud" given in Collier on Bankruptcy (Vol. 3A, Section 63.06 5.3, page 1793), which warrant disallowance or postponement of a control persons claim are revealing; i.e. where stockholders claim to be creditors of the bankrupt by reason of repurchase agreements; where stockholders permitted the corporation to reflect on its statement less than the full amount allegedly owed to permit the corporation to make a better showing; where claims are asserted for accrued salary or for extra compensation.

The cases cited by the Appellee at page 18 of her brief are to the same effect. In Kraft Foods Co. v. Commissioner 232 F. 2d 118, 125 (2d Cir. 1956) is a tax case; In Gannett Co. v. Larry 221 F. 2d 269, (2d Cir. 1955) the claim of the parent corporation was subordinated because the bankrupt had not been operated with a profit motive, but rather to secure for itself an emergency source of newsprint; In International Telephone & Telegraph v. Holton 247 F. 2d 178 (4th Cir. 1957) was decided on the "Thin Corporation" rule. As to the cases cited by the Appellee at page 24 of her brief, -- In Bank of America National Trust & Savings Association v. Erickson, 117 F. 2d. 796 (9 Cir. 1941), the debt of the creditor was subordianted

pursuant to a written agreement signed by the creditor consenting thereto. In Taylor v. Standard Gas Co. 306 U.S. 307, 59 S. Ct. 543, 83L. Ed. 669 (1939), the Court subordinated the claim of the parent corporation to that of preferred stockholders because the parent had been guilty of wrongful and injurious conduct in the mismanagement of the bankrupt's affairs. Costello v. Fazio 256 F. 2d 903 (9 Cir. 1958) was another instance of the application of the "Thin Corporation" rule.

In the instant case, the alleged "fraud" upon which Appellee relies for disallowance or postponement of Appellant's claim appears in her brief twice. At page 11 thereof, she states "that the transaction in question was devised by Centrella as a scheme by which he would enable himself to gain parity with the bona fide general unsecured creditors of Madero." At page 16 she states "this transaction was not entered into openly and in good faith, and it was inherently unfair from the viewpoint of the bankrupts' general unsecured creditors, as it was a surreptitious attempt by a silent stockholder to gain parity with the genuine creditors of the corporation for his infusion of capital into his failing business."

This, in effect, is a repitition of the basis of the decision of the Referee. Its reiteration does not make

it any more valid. Immediately prior to making the moneys available to the corporation, Centrella, the lender (as found by the Referee) had to decide two issues. One, whether he should advance any money, and second, whether such advance should take the form of a loan or of an additional investment. Once having decided to advance the funds, the choice as to whether it should be a loan or an investment was his, without right on anyone's part to review the determination which he made. (Rowan v. U.S., 219 Fed. 2d 51, and other cases cited in Appellant's Point I)

That he decided to advance moneys as a loan to the corporation which put him on a parity with other creditors thereof, was perfectly proper, legitimate and sanctioned by these decisions. That he had such purpose in mind does not stamp the loan as unfair, or made in bad faith, nor render his determination inequitable. It does not taint the loan. In fact, under the principals there enunciated, it would have been proper for him to have taken security for the repayment of the loan.

Appellee suggests at page 19 of her brief "that this influx of money should have initially gone on the company books as a contribution to capital by a shareholder rather than as a loan," but there is no duty nor obligation to do so. Control persons are the ones most interested in

restoring and reviving the credit of their corporation and as long as they do not abuse their position and better knowledge to secure to themselves some unlawful preference, neither creditors nor society have reason to look upon their efforts with anything but approval." (3A Collier on Bankruptcy, Section 63.06 (5th Ed. 1789)

IV

At page 21 of her brief, Appellee spends some time on a discussion of the debt-capital ratio of the bankrupt at the time the loan was made. Appellant does not believe that this is germane. The "Thin Corporation" rule does not apply to a corporation which has been in business for more than nine years, with a capital sufficient to encounter the vagaries of the textile business over such an extended period, and which, in its tenth year, obtains a loan from its control person so that it may avoid paying interest to its factor at more than 10%, per annum.

V

By Point II of her brief, Appellee seeks to have the claim herein subordinated, if the Court does not sustain the Referee's determination that it be expunged. This is an exercise in semantics. Though the bankrupt estate will pay a substantial dividend to its general creditors, it will not be able to discharge those debts in full. To subordinate

the claim herein to these general debts would have the same result as to expunge the claim, nothing will be paid on account thereof. Subordination of the claim depends on the same factors which would support expunging it. As, under the law the claim should not be expunged, similarly, it should not be subordinated.

CONCLUSION

The Order of District Court, dated June 28, 1974, and entered July 2, 1974, and the Order of the Bankruptcy Referee dated October 31, 1973, should be reversed and the Trustee's motion to expunge the claim of PAULINE GREEN for moneys lent to the bankrupt should be denied.

Dated: October 31, 1974

Respectfully submitted,

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A 202 Affidavit of Personal Service of Papers H LUTZ APPELLATE PRINTERS

US COURT OF APPEALS: SECOND CIRCUIT

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Bankrupt

GREEN,
Claimant-Appellant *against*

LOWE,
Trustee-Appellee.

Index No.

Affidavit of Personal Service

STATE OF NEW YORK, COUNTY OF NEW YORK *ss.:*

I, Victor Ortega, *being duly sw o*

deposes and says that deponent is not a party to the action, is over 18 years of age and resides

1027 Avenue St. John, Bronx, New York

That on the 4th *day of* November *1974 at* 1290 6th Ave., New York

deponent served the annexed Reply Brief

Sherman & Citron

the *in this action by delivering a true copy thereof to said individ personally. Deponent knew the person so served to be the person mentioned and described in sa papers as the* Attorney(s) *herein,*

Victor Ortega

Print name beneath signature

VICTOR ORTEGA

Sworn to before me, this 4th
day of November *19* 74

Robert T. Brin

ROBERT T. BRIN
NOTARY PUBLIC, STATE OF NEW YORK
NO. 31 - 0416950
QUALIFIED IN NEW YORK COUNTY
COMMISSION EXPIRES MARCH 30, 1975